

December 15, 2002

**To the Honorable Mayor and Members of the City Council
City of Durham, North Carolina**

The Comprehensive Annual Financial Report (CAFR) of the City of Durham (City) for the fiscal year ended June 30, 2002 (FY 2001-02) is hereby submitted. As required by North Carolina General Statutes (NCGS), the CAFR includes financial statements that have been audited by an independent certified public accounting firm. Responsibility for the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the City. To the best of our knowledge and belief, the enclosed data accurately presents the financial position and the results of operations of the City as measured by the financial activity of its various funds. All disclosures necessary to enable the reader to gain an understanding of the City's financial activities have been included.

The CAFR is presented in five sections: Introductory, Financial, Accompanying Financial Schedules, Statistical, and Single Audit. The Introductory Section includes this letter of transmittal, an organization chart and a copy of the Certificate of Achievement for Excellence in Financial Reporting. The Financial Section contains the Independent Auditors' Reports, combined statements, notes to the financial statements and more detailed combining and individual fund statements and schedules. The Accompanying Financial Schedules includes selected unaudited schedules related to budget, taxes, assessments and debt. The Statistical Section provides selected financial and general information. The Single Audit Section includes the Independent Auditors' Reports on internal controls and compliance with laws and regulations, and a schedule of expenditures of federal and state awards. This section has been prepared in accordance with the provisions of the Single Audit Act, U.S. Office of Management and Budget Circular A-133 and NCGS 159-34.

The financial reporting entity includes all of the City's funds. Component units are legally separate entities for which the City has financial control. Financial control by or dependence on the City is determined on the basis of budget adoption, taxing power, outstanding debt secured by the revenues or general obligation of the City or the obligation of the City to finance any deficits or receipt of significant subsidies from the City. Based on these criteria the City does not have any discretely presented component units. Blended component units are legally separate entities; however, in substance, their operations are included as part of the primary government.

PROFILE OF THE CITY OF DURHAM

Durham is a city nestled on the rolling hills of central North Carolina. It is the fourth largest city in the state, the county seat, and the only municipality in Durham County. The city takes pride in its educational, cultural, athletic, and medical assets. Durham covers an area of 98.2 square miles. The estimated population of 194,405 includes a rich diversity of racial and ethnic backgrounds

The City of Durham has operated under the Council-Manager form of government since 1921. Durham City Council is comprised of seven members: three members from specific wards, three at-large members and the Mayor. The terms for City Council seats are staggered, and nonpartisan elections are held every two years. The ward members elected in 2001 serve a four-year term. The at-large seats filled in 2001 will be contested in 2003, and those elected in 2003 will serve a four-year term. City Council is the legislative and policy-making body for Durham and is the final authority on most matters relating to the City. The Council is responsible for establishing general policies for the City; appointing the City Manager, City Attorney, City Clerk and members of various boards and commissions; enacting ordinances, resolutions and orders, reviewing the annual budget, and authorizing contracts on the City's behalf.

The Mayor serves as presiding officer of the City Council and votes on all matters that come before the body. The Mayor also appoints standing and special committees of the Council, unless the Council votes to elect such committees. As official head of city government, the Mayor represents the City on ceremonial occasions. The City Manager is the administrative head of city government and is responsible for the efficient management of City operations. The Council appoints the Manager, who ensures that ordinances and policies set by Council are carried out. The Manager is also responsible for preparing the annual budget and for supervising city departments and personnel (except the City Attorney's and City Clerk's offices). As an employee of the City Council, the Manager normally attends all Council meetings.

City government services are headquartered at Durham's City Hall in downtown Durham. Service facilities including police and fire stations, recreational facilities and public works operations can be found throughout the community.

The City of Durham's annual budget process, the framework for communicating major financial operational objectives and for allocating resources to achieve them, is a complex undertaking involving the whole government. The process begins in October and runs until the end of June. By State law, the City must adopt an annual budget ordinance by June 30th of each year. As part of the budget process the City Council holds two public hearings on the budget, one in January at the beginning of the budget process and one in June prior to adoption as mandated by State law. City departments are required to submit budgets to the City Manager in March and those requests are used as a starting point for the development of a preliminary budget to be presented to City Council.

Once the budget is approved, the focus of the budget is upon control. Ongoing monitoring of expenditures and revenues throughout the year is a responsibility shared by department directors and the Budget Department. The Accounting Services Division of the Finance Department ensures that changes are correctly entered and payments are appropriate.

The Budget and Management Services Department reviews all requests from departments to make sure that sufficient appropriations have been budgeted. All funds are reviewed on a regular basis, and a budget report is submitted to the City Council on a quarterly basis.

The City Manager has the authority to transfer budgeted amounts between departments within any function. However, transfers between functions, additions, or deletions require a budget amendment. To amend the budget, a revised budget ordinance must be approved by the City Council.

Budget to actual comparisons are provided in this report for each individual governmental fund for which an appropriated annual budget has been adopted. For the General Fund, this comparison is presented on page 26 as part of the basic financial statements for the governmental funds. For governmental funds, other than the general fund, with appropriated annual budgets, this comparison is presented in the governmental fund subsection of this report, which starts on page 27.

FACTORS AFFECTING FINANCIAL CONDITION

Regional Picture: The Raleigh-Durham-Chapel Hill Metropolitan Statistical Area (MSA) has one of the strongest, most stable economies in the nation. In 1995 through 1998, the Raleigh-Durham-Chapel Hill MSA was rated as having the best long-term economic performance of all 316 metropolitan areas in the United States; the region was ranked 6th nationally in 2001 and 2002. National magazines consistently give the region top rankings for quality of life, higher education, overall business climate, small business and entrepreneurial opportunities, business climate for women, and combining work and family life. In June of 2002, Employment Review rated the area as the #1 Best Place to Live and Work in America.

Location and Accessibility: The City is located in the heart of an MSA with a population of over 1.1 million. The City borders the Research Triangle Park (RTP) on three sides. RTP, recognized internationally as a center for cutting-edge research and development, is the largest research park in the United States. RTP covers over 7,000 acres and is home to more than 140 organizations. Durham is centrally located among the major population centers of the East Coast, and is bisected by Interstates 85 and 40, which are connected by the Durham Freeway. Raleigh-Durham International Airport (RDU), located just east of the City limits, served over 9.5 million passengers and moved 121,467 tons of cargo in 2001. There are about 220 daily departures from RDU, which is served by 10 major airlines, providing non-stop service to 42 cities.

Employment Base in Research and Manufacturing: The City's diverse and expanding economy is rooted in electronics, health care, medical research, education and telecommunications. The "City of Medicine" is one of the nation's leading centers for

biotechnology and medical research. Of the State's 137 biopharmaceutical companies, 64 are located in Durham County. Duke Medical School is ranked the 5th Best Medical School in the Country for Research and Duke Hospital is ranked 6th Best Hospital in the Country by U.S. News. Duke University and Duke Medical Center employ 20,000 people, while spin-offs from research at Duke, the University of North Carolina at Chapel Hill, and North Carolina State University have created dozens of start-up biotech firms. These companies are supported by the state-sponsored North Carolina Biotechnology Center, located in Research Triangle Park.

Ninety-five percent of the companies currently operating in Research Triangle Park are located in Durham County. RTP employs roughly 42,000 people in such leading firms as IBM, GSK, Cisco Systems, Nortel Networks, Novartis, and Aventis. Another 50,000 people are employed at the numerous manufacturing facilities, office parks, and flex buildings located in the City just outside of RTP, complementing the research and development activities inside the Park.

Treyburn Industrial Park in northern Durham County employs 2,000 people in firms including Becton-Dickinson, Organon Technika, Cormetech, and Fruedenberg. Despite the City's reputation as a center of research and development activities, Durham is one of the few areas in the Country where both the size and percentage of the manufacturing workforce is increasing as well.

Unemployment in Durham has averaged 2.6% over the past five years, and has been consistently below the state and national averages. After reaching a record-low of 1.9% in 1999, unemployment increased to 3.4 in 2001 and to 5.4% in 2002, which was still significantly lower than the State level of 6.5%. For fiscal year 2002 total employment state-wide decreased 1.09%, while Durham had a slight increase in total employment 0.06%.

Education and Job Training: The education and skill level of the labor force is a major factor in the desirability of the Durham area. Over 35% of Durham County adults possess at least a Bachelor's degree, compared with 20% nationally. The community college system - particularly the system's interaction and cooperation with businesses to establish training programs - is regarded as one of the best in the nation. In-migration continues to add to the work skills and brainpower needed by our growing companies.

Construction Trends: The City continues to witness strong and solid levels of private investment, with values of building permits totaling \$ 561 million in fiscal year 2002. Downtown Durham is targeted as an area of particular strategic and symbolic importance, and has seen such recent successes as the 250-unit West Village apartments (a renovation of historic tobacco industry buildings), the Durham Bulls Athletic Park, renovation of the 1904 TeerMark office building, and the fully leased, 90,000 square foot Diamond View office building. Other adaptive re-use successes downtown include the City Place offices and Measurement Incorporated's headquarters expansion. Several major downtown projects are currently in the planning stages. The American Tobacco Project, which is planned to begin construction in January of 2003 includes approximately one million square feet of mixed use space located in abandoned historic tobacco manufacturing and warehouse buildings. The project will be completed in several phases with the first phase, scheduled to be completed in spring of 2004, with over 300,000 sq feet of office space bringing 1,400 jobs to the downtown. Outside of

downtown, Urban Retail Properties completed construction of the \$220 million Streets At Southpoint Mall, which opened in March 2002.

The majority of new development in Durham County takes place within the city limits, and the City's annexation policy is to protect our present and future tax base.

Retail Sales: Fiscal year 2002-2003 retail sales in the City of Durham increased by 10.7% over the previous year. Retail sales have doubled since 1990 with an average annual growth of more than 9%.

MAJOR INITIATIVES

For the Year 2002-03

The FY 2002-03 Budget reflected the following community goals that were adopted by the City Council:

- To improve the quality of life by reducing the incidence of crime
- To improve the quality of life by addressing the root causes of crime.
- To improve the quality of life by ensuring the availability of, and access to, adequate, safe, and affordable housing for every resident.
- To provide economic development activities that increase citizen access to high quality jobs while increasing the City's tax base.
- To improve the livability of the City by managing the City's growth, protecting and preserving the environment, and maximizing the use of public infrastructure.
- To improve the City's image by preserving and enhancing the community's aesthetic beauty and natural assets, and by building upon the rich and diverse cultural heritage of the community.

The following events are highlights of the 2001 – 2002 fiscal year:

- **Reducing the incidence of crime.**
 - Implementation of the Cognos Crime Analysis System.
 - Establishment of a Crime-Stoppers Program in the school system.
 - Establishment of a Warrant squad.
- **Addressing the root causes of crime**
 - Held four Community Gang Forums to allow citizens to learn what the City of Durham and community agencies are doing to reduce the negative influence and impact of gangs in the communities.
 - Conducted "Connecting Communities to Opportunity" workshops to discuss strategies to effectively connect underserved neighborhoods to the various opportunities that exist in Durham.
- **Ensuring the availability of, and access to, adequate, safe, and affordable housing for every resident.**
 - Completed housing condition surveys in Partners Against Crime Districts 1, 3 and 4 to assist with establishing a baseline measure for vacant and substandard housing in the City.

- Initiated code enforcement process on 199 vacant structures identified in housing conditions survey.
- Developed Police and Teacher Homeownership Programs.
- Developed Tenant-based Rental Assistance Program.
- **Providing economic development activities that increase citizen access to high quality jobs while increasing the City's tax base.**
 - Placed 3,682 individuals in employment through JobLink Career Center
 - Paced 175 Welfare to Work participants in employment opportunities
 - Expanded summer program opportunities giving over 200 Durham youth work experience.
- **Managing the City's growth, protecting and preserving the environment, and maximizing the use of public infrastructure**
 - Initiated development of multiple elements of a new comprehensive plan for Durham based on *SmartGrowth* principles.
 - Completed the Trails and Greenways Masterplan, the NC54/I-40 Corridor Plan and the Northeast and West/Northwest Durham Small Area Plans.
 - Initiated Development of the Unified Development Ordinance.

FINANCIAL INFORMATION

Accounting System and Budget Control

From an accounting and financial management viewpoint, a governmental unit contains several different fiscal and accounting entities that function independently. Each accounting entity is accounted for in a separate "fund". A fund is a self-balancing set of accounts recording cash and other financial resources together with related liabilities and residual equities or balance and changes therein. Each entity is segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations. For financial reporting purposes funds are combined as well as reported separately (for major funds) to give a clear picture of the results of operations of the entire organization and its key functions.

The new reporting model mandated by the Government Accounting Standards Board (GASB) Statement 34 establishes a new financial reporting framework for state and local governments. This report represents the first year the City of Durham is reporting under GASB 34. The major changes included in the new reporting framework include the following:

- **Government-wide financial reporting** - Traditionally, for reporting purposes, funds have been aggregated into specific groupings such as "Enterprise Funds and Special Revenue Funds without attempting to create entity-wide statements representing all of the activities of the government regardless of fund classification. Under GASB 34, government-wide statements provide a picture of the City as a single unified entity.
- **Long term focus for governmental activities** – The reporting focus for tax supported (governmental) activities has traditionally been on short-term inflows and outflows and spendable balances. Although this short-term focus will remain the same for governmental fund statements, the government wide financial statements will provide a long-term perspective on governmental activities.
- **Management's Discussion and Analysis (MD&A)** – An additional feature of the new reporting model is a narrative overview and analysis of the financial statements.

- **Major Fund Information** – Individual fund statements are presented for each of the City’s major funds.
- **Expanded Budgetary Reporting** – Aggregated fund budget comparisons have been eliminated in favor of individual budget presentations for each major fund. Also information on original budget amounts as well as final amended budgets are presented.

The City’s accounting records for general governmental operations are reported on the modified accrual basis, whereby revenues are recognized when measurable and available and expenditures are recognized when goods and services are received. Accounting records for the City’s proprietary and pension trust operations are reported on the full accrual basis.

The City’s internal accounting controls are designed to provide reasonable, but not absolute, security of assets against loss from unauthorized use. The controls are also essential for sustaining the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that (1) the cost of control should not exceed the benefits likely to be derived; and (2) the evaluation of costs and benefits requires estimates and judgments by management.

As a recipient of Federal and State financial assistance, the City also is responsible for maintaining an adequate internal control structure to ensure compliance with laws and regulations related to those programs. As a part of the single audit, tests are made to determine the adequacy of the internal control structure and its compliance with applicable laws and regulations. The results of the City’s single audit for the fiscal year ended June 30, 2002 provided two instances of significant violations of applicable laws and regulations. There were four minor instances of reportable conditions in the internal controls structure. The City has implemented processes to correct any weaknesses in the internal controls structure.

Budgetary controls are maintained to ensure compliance with the budget as adopted or amended by City Council. The North Carolina General Statutes require the adoption of an annual budget for all funds except those for which expenditures are authorized by project ordinance, fiduciary funds and internal services. In those instances a project ordinance or financial plan is adopted by the City Council. The City Manager has the authority to transfer budgeted amounts between departments within any category. However any revisions that alter the total appropriations of any category or fund must be approved by the City Council.

Encumbrance accounting under which purchase orders, contracts and other commitments for the expenditure of monies are recorded in order to reserve that portion of the applicable appropriation is employed in all governmental funds. Encumbrances outstanding at year-end are reported as reservations of fund balance. Funds to cover outstanding encumbrances are re-appropriated through the budgetary process.

General Fund Balance

The City Council has adopted a policy of maintaining an undesignated fund balance of no less than 12% of budgeted appropriations, adjusted for debt service and transfers to other funds. The FY 2002 undesignated fund balance is 10.65% of FY 2003 budgeted appropriations adjusted for

debt service and transfers to other funds. In preparation for the implementation of GASB 34, the City closed most of the Internal Services Fund at the end of FY 2001.

Debt Management

The City's sound financial condition is evidenced by the maintenance of AAA/Aaa bond ratings for general obligation debt from Moody's, Standard and Poors and Fitch IBCA. The City is one of the few municipalities to receive the highest general obligation bond ratings from the three rating agencies. The City's credit ratings for general obligation and water and sewer revenue debt are listed below:

	Standard & Poor's	Fitch IBCA	Moody's
General Obligation	AAA	AAA	Aaa
Water and Sewer System Revenue Bonds	AA	AAA	Aa3

These strong credit ratings allow the City to issue debt at interest rates considerably below the Bond Buyer's Index, thereby achieving significant savings.

As of June 30, 2002, the City had debt outstanding of \$398,211,987, consisting of \$231,240,003 outstanding general obligation bonds, \$53,390,000 in revenue bonds, \$68,750,000 in Certificates of Participation, \$32,139,493 due to Durham County for purchase and improvements to sewer lines, \$12,434,476 in a loan from the state to improve a sewer treatment plant.

Bonds authorized but unissued at June 30, 2002 were \$26,772,000 consisting of:

Housing	\$ 11,286,000
Park & Recreational facilities	\$ 2,603,000
Public Transportation	\$ 1,715,000
Streets	\$ 11,168,000
Total	\$ 26,772,000

Cash Management

Effective forecasting of cash requirements and progressive cash management has allowed the maximum use of all available cash resources. For the year ended June 30, 2002, the City's Gross investment income was \$7,001,486, which is an adjusted decrease of \$3,265,612 from the previous fiscal year. This amount includes a GASB Statement 31 market value increase in the amount of \$2,090,530. The City's average weighted yield to maturity for the pooled cash at June 30, 2002, was 3.06%.

The City uses the pooled cash and investment concept in investing excess cash for all funds. The goal of the City's investment policy is to minimize credit and market risk while receiving high returns on investments. The investment policy of the City is guided by NCGS 159-30, which stipulates that the City can only invest in certificates of deposit, repurchase agreements, secured time deposits, banker's acceptances, commercial paper, and United States government and agency securities.

Risk Management

The City has established Risk Management programs to (1) identify potential exposure to loss, (2) evaluate the frequency and severity of losses, (3) determine the most efficient use of financial resources to pay for losses that are not preventive, (4) reduces or eliminates risks or losses through procedures and practices. Additional information relative to insurance coverage and risk retention is presented in the Notes to the financial statements.

OTHER INFORMATION

Independent Audit

State Statutes require an annual audit by independent certified public accountants. The accounting firm of Cherry, Bekaert & Holland was selected by the City Council. In addition to meeting statutory requirements, the audit also complies with the Federal Single Audit Act, Office of Management and Budget Circular A-133, and NCGS 159-34 (Single Audit Implementation Act). The auditor report on the general-purpose financial statements and combining and individual fund statements and schedules are included in the financial section of this report. The auditors' reports on internal controls and compliance with applicable laws and regulations are included in the Single Audit Section.

Awards and Acknowledgements

The Government Finance Officers Association of the United States and Canada (GFOA) once again recognized the City for the quality of its Comprehensive Annual Financial Report issued for the previous fiscal year. In order to be awarded a Certificate of Achievement, the City must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and accepted legal requirements. This Certificate of Achievement for Excellence in Financial Reporting marks the 17th consecutive year and the 21st time in 23 years that the City has been so honored.

A Certificate of Achievement is valid for a period of one year only. We believe that our current report continues to conform to the Certificate of Achievement Program requirements, and we are submitting the report to GFOA to determine its eligibility for another certificate.

In addition, the City of Durham also received the GFOA's Distinguished Budget Presentation Award for its annual budget document for the fiscal year beginning July 1, 2001. In order to qualify for the Distinguished Budget Presentation Award, the City of Durham's budget document was judged to be proficient in several categories, including as a policy document, a financial plan, an operations guide, and a communications device.

Preparation of this report would have been impossible without the hard work and dedication of the Department of Finance Staff. In particular the efforts of the Accounting Staff and the Financial Reporting Team should be recognized. Other departments of the City have also contributed directly or indirectly in the preparation of this report and their cooperation and continued assistance is appreciated.

We also greatly appreciate the ongoing support and guidance we receive from the Mayor and the City Council.

Respectfully submitted,

Marcia L. Conner
City Manager

Kenneth C. Pennoyer
Acting Director of Finance